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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 555

R. H. OSWALD COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court of the United States (R. 74-82) is not officially reported. The opinion of the Court of Appeals (R. 108-113) is reported in 185 F. 2d 6.

JURISDICTION

The judgment of the Court of Appeals was entered on November 10, 1950. (R. 114.) A petition for rehearing was denied on December 15,

1950. (R. 129.) The petition for a writ of certiorari was filed on February 15, 1951. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the court below correctly decided that the amounts fixed by the Tax Court as reasonable salaries under Section 23 (a)(1)(A) of the Internal Revenue Code were not clearly erroneous.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra,* pp. 9-11.

STATEMENT

The facts as found by the Tax Court (R. 74-80), may be summarized as follows:

The taxpayer, a corporation, engaged in the wholesale grocery and fresh fruit and vegetable business, kept its books and made its returns on the accrual basis; it filed income, declared value excess profits, and excess profits tax returns for the taxable years, the fiscal years ended June 30, 1943, and June 30, 1944. (R. 74, 78, 79.) The taxpayer's capital stock was $30,000 and since November, 1937, R. H. Oswald, the president, has owned 290 of the 300 shares outstanding; his wife and brother each owned five of the remaining shares. (R. 74-75.) He has had extensive experience in the grocery, fruit and vegetable business and has been president and

general manager of the taxpayer since 1922. (R. 78.) Beginning with the year 1938 he performed all the executive and managerial duties of the taxpayer's business. (R. 78-79.) He worked long hours and never took a vacation. (R. 79.) In 1930 the board of directors by resolution authorized a salary of $7,200 to Mr. Oswald and in addition a percentage of the earnings when the latter exceeded 20% on the outstanding stock. (R. 75-76.) Under this resolution he received for the year 1930 an aggregate salary of $10,604.81; for the year 1931, $9,582.38; and for the year 1936, $8,595.31. Otherwise, his salary for the fiscal years 1930 to 1942, inclusive, did not exceed $7,200 per year. (R. 11.) In 1942 the taxpayer's board of directors voted him a salary of $800 per month ($9,600 per year), and when the net worth of the company should exceed $75,000, then all earnings above 80% on the par value of the outstanding stock,[1] as additional salary. (R. 14-15, 76.) A similar resolution was passed in 1943 and 1944. (R. 76.)

The taxpayer's net worth having exceeded $75,000 in the taxable years (R. 77), Mr. Oswald was paid a salary of $45,767.83 for 1943 and $48,503.12 for 1944 (R. 75). The taxpayer had paid no cash dividends since the fiscal year 1932. (R. 75.)

The Commissioner disallowed that part of the salaries paid Mr. Oswald for 1943 and 1944 in ex-

[1] $24,000 (80% of $30,000).

cess of $9,600 for each year. (R. 7.) Upon appeal to the Tax Court a reasonable allowance for compensation was fixed at $22,500 for 1943 and $25,000 for 1944. (R. 80-82.) Not satisfied with this substantial increase over the amount allowed by the Commissioner, the taxpayer appealed to the court below which affirmed the decision of the Tax Court (R. 108-113) and subsequently denied a petition for rehearing (R. 129).

ARGUMENT

The question as to what is a reasonable allowance for salary within the meaning of Section 23 (a) (1) (A) of the Internal Revenue Code and Sections 29.23 (a)-6 and 29.23 (a)-8 of Treasury Regulations 111, Appendix, *infra*, pp. 9-11, is essentially a question of fact. The amounts fixed by the Tax Court in this case are within the range of the evidence. The salary paid Mr. Oswald for six successive years preceding the taxable years was $7,200 (R. 11); the resolutions passed by the board of directors in 1943 and 1944 provided for a basic salary of $800 per month, or $9,600 per year, before adding a contingent share of the taxpayer's earnings as additional salary (R. 76); in accordance with the resolutions, Mr. Oswald was actually paid more than $45,000 for the fiscal year 1943 and more than $48,000 for the fiscal year 1944 (R. 80). The amounts fixed by the Tax Court, $22,500 for 1943 and $25,000 for 1944 (R. 80), are somewhere between the amount determined by the Commis-

sioner, $9,600 for each year (R. 7), and the amounts claimed by the taxpayer. There was evidence in the record to support the finding of lower salaries than $22,500 and $25,000 for the taxable years and also evidence to support higher salaries than those found by the Tax Court; thus, the Tax Court exercised its function as trier of the facts to weigh the evidence and reached the conclusion that $22,500 and $25,000 constituted reasonable salaries for the taxable years. The statement in the opinion of the court below that it found "no evidentiary basis for an allowance of these particular amounts" (R. 113), is not material, since the amounts found by the Tax Court were within the range of the evidence. The opinion of the court below (R. 108-113) shows that that tribunal carefully considered all of the evidence in the case and found sufficient factual support for the Tax Court's conclusion, so that it was unable to say that the decision of the Tax Court was clearly erroneous. Under similar circumstances this Court has repeatedly declined review. *Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593 (C.A.2d), certiorari denied, 311 U. S. 680; *Anthony P. Miller, Inc.* v. *Commissioner,* 164 F. 2d 268 (C.A.3d), certiorari denied, 333 U. S. 861; *Gem Jewelry Co.* v. *Commissioner,* 165 F. 2d 991 (C.A.5th), certiorari denied, 334 U. S. 846; *Ecco High Frequency Corp.* v. *Commissioner,* 167 F. 2d 583 (C.A. 2d), certiorari denied, 335 U. S. 825; *L. E. Pinkham*

Med. Co. v. *Commissioner,* 128 F. 2d 986 (C.A. 1st), certiorari denied, 317 U. S. 675; *Em. H. Mettler & Sons* v. *Commissioner,* 181 F. 2d 848 (C.A. 9th), certiorari denied, 340 U. S. 877.

The taxpayer contends that the decision of the court below is in direct conflict with the decision of other Courts of Appeals in which it was held that the Tax Court may not reject the testimony of an expert witness where there is no other testimony on the subject and where the Tax Court itself does not have any independent knowledge, experience or judgment of its own regarding the subject-matter. (Pet. 6-7; Br. 10-13.) Only one of the cases cited by the taxpayer (Pet. 7; Br. 11-13) involves the reasonableness of salaries, *Capitol-Barg Dry Clean. Co.* v. *Commissioner,* 131 F. 2d 712, 715 (C.A.6), and in that case the court indicated that it depended upon its peculiar facts. Consequently, there is no direct conflict of decisions. This Court has held in a case involving the valuation of property that opinion evidence is not conclusive, and that a failure to follow such opinion evidence alone is not an error of law. *Dayton P. & L. Co.* v. *Comm'n,* 292 U. S. 290, 299.

Moreover, this case does not conflict with the rule announced in the cases relied on by the taxpayer, for the fundamental premise of that rule, that there be no evidence other than that of the expert, does not exist here. The record shows Mr. Oswald's salary for a period of more than 20 years;

his highest salary prior to the taxable years was $10,604.81 in 1930; and he received $7,200 a year for six successive years immediately preceding the taxable years. (R. 11.) There was no evidence to show such an increase in hours of work and duties between 1942 and 1943 as to justify an increase in salary from $7,200 to $45,767.83. Furthermore, the record shows that since November, 1937, Mr. Oswald owned 290 of 300 shares of the taxpayer's stock, or more than 96%, so that he was entitled to substantially all of the taxpayer's earnings; and no cash dividends have been paid since 1932. (R. 75.) As Section 29.23(a)-6 of Treasury Regulations 111, Appendix, *infra*, pp. 9-11, points out, an ostensible salary paid by a corporation to its principal stockholder may be a distribution of a dividend on stock. The circumstances here warrant that inference. It also may be noted that the taxpayer's failure to introduce evidence of the salary paid for similar services by a single corporation in a similar business under like circumstances justifies the inference that other concerns in the same sort of business did not pay salaries as high as those paid by the taxpayer.

CONCLUSION

The decision of the court below is correct and depends upon the circumstances of this particular case. There is no conflict of decisions, and further review is not warranted. The petition for a writ of certiorari should be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
HELEN GOODNER,
MORTON K. ROTHSCHILD,
Special Assistants to the Attorney General.

MARCH, 1951.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23 (a)-6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. * * *.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduc-

tion even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

SEC. 29.23 (a)-8. *Bonuses to Employees.*— Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

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